



Report to the Legislature

The Fiscal Impact of Rebasing Payment to Nursing Facilities at Different Intervals

Chapter 8 Laws of 2001, E1, Section 18 (4)

July 1, 2002

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EXECUTIVE SUMMARY

This report, The Fiscal Impact of Rebasing Payments to Nursing Facilities at Different Intervals, is made pursuant to Chapter 8, Laws of 2001 E1, Sec. 18 (4), which states:

By July 1, 2002, the department of social and health services shall report to the joint legislative task force on nursing homes and provide an evaluation of the fiscal impact of rebasing future payments at different intervals, including the impact of averaging two years' cost data as the basis for rebasing. This report shall include the fiscal impact to the state and the fiscal impact to nursing facility providers.

This report evaluates the fiscal impact of rebasing future payments to nursing homes at different intervals of time, including one year, two years, and three years. In evaluating the impact of rebasing on a three-year interval, two models are used. In the first model, all homes are rebased every third year. In the second model, one-third of the facilities are rebased each year. This report also examines the alternative of applying a vendor rate increase rather than utilizing a system of rebasing.

This report concludes that, if the policy choice is made to rebase nursing home rates in the future, the best alternative is an interval of three years for rebasing, and rebasing one-third of the facilities each year. This alternative would have a positive fiscal impact on the state by producing a more accurate reflection of nursing home costs, while at the same time permitting more effective and efficient use of state resources.

This report also points out that, while rebasing has been a feature of Washington's nursing home payments in the past, it is not a benefit provided to other service providers. One policy choice may be to use vendor rate increases as the mechanism for increasing nursing home payments, rather than allowing nursing home rates to be rebased in addition to receiving the vendor rate increase.

COST REPORTS

Each nursing facility that contracts with the Department of Social and Health Services (DSHS) to provide services to Medicaid recipients is required by RCW 74.46.040 to file a cost report each year with the Office of Rates Management (ORM), a section of DSHS' Aging and Adult Services Administration. On the cost report, the nursing facility records all of the costs that it claims are allowable under state and federal Medicaid laws. The seven components of a nursing facility's overall per patient day (ppd) Medicaid payment rate are based on reported allowable costs. The components are direct care, therapy care, support services, operations, variable return, property and financing allowance.

Each facility files a cost report for each year, but not every year's cost report is used in the same way. Currently, RCW 74.46.431 provides that the 1999 cost report information be used to establish nursing home rates for the rebase period of July 1, 2001 through June 30, 2004. Historically the legislature has approved a vendor rate increase each year to account for increased expenses after the rebase year as well as the rebase year itself. One exception is that the property and financing allowance component rates are reset annually on July 1, using the prior year's cost report information. For example, July 1, 2002 prospective payment rates will use adjusted figures from the 1999 cost reports for the direct care, therapy care, support services, operations, and variable return components, but will use examined and adjusted figures from the 2001 cost reports for the property and financing allowance components. None of the alternatives would impose new reporting requirements on facility operators.

REBASING

"Rebasing" is the process of using a new, usually more recent cost report to establish Medicaid payment rates. The cost reporting period that is fully examined in order to set new Medicaid rates is referred to as the "rebase year." The past two rebase years were 1996 and 1999. Rebasing usually results in higher payment rates since more recent cost reports usually reflect higher costs. Most organizations that provide services to the state receive increases in their payment rates through the mechanism of the vendor rate increase. Nursing home Medicaid payments have historically received rate increases through both rebasing and the vendor rate increase.

The Legislature has changed the interval between nursing home rebase years three times in the past seventeen years. Nursing home Medicaid rates were rebased annually from 1985 through 1991. During these years, the average yearly percentage of growth of the Medicaid rates was 10%. From 1992 through 1995, rebasing was done every other year. The annual percentage of growth of nursing home Medicaid rates during these years was between 6% and 9%. Beginning in 1996, rebasing has been performed every three years, with 1999

being the last rebase year. The annual percentage of nursing home Medicaid rate growth from 1996 to 2000 was between 3% and 5%. The vendor rate increase for other long-term care services drove an increase in payments of approximately 2% per year over the same approximate period.

When rebasing occurs every year, a nursing home provider knows that the expenses incurred in one year will be recognized in the Medicaid rate in subsequent years, so the owner has less incentive to control costs. However, if the provider knows that the purchases made in a non-rebase year will not be recognized, it is reasonable to expect that the owner will not make unnecessary nor untimely purchases until the next rebase year. Extending the time between rebase years tends to control growth in nursing home costs, and therefore the Medicaid rates.

The changes in the intervals for rebasing, along with other simultaneous changes in the methodology for calculating Medicaid payment rates, make it difficult to determine precisely how different rebasing intervals have affected the nursing home payment system. However, even if specific estimates of the fiscal impacts of various rebasing intervals are hard to determine, the relative impacts of alternative intervals can be compared.

The impact of nursing home Medicaid rates is significant to Washington state's budget that is set by the Legislature. Medicaid payments to nursing homes in 2001 were approximately \$487 million. Of this amount, almost half came directly out of the state's general fund. Therefore, information related to what the average Medicaid rate will be plays a significant role in determining Washington's budget.

Legislative budget decisions are normally finalized during the Legislative session in the spring of each year. Any system that bases a payment rate on cost reports that are less than two years old allows only for an estimate of what the rate will be, and lends an uncertainty into the state budgeting process.

Several rebasing alternatives considered in this report assume that we will continue the current practice of rebasing the property and financing allowance components annually. One option discusses the policy choice to reduce the frequency of rebasing capital.

CURRENT REBASING SYSTEM

The current payment system of rebasing five cost centers every three years has been used for two cycles. This system requires cost reimbursement analysts to examine cost reports every three years to establish rates for the rebase year. For example, the 1999 cost report was fully examined in order to set the July 1, 2001 Medicaid payment rates for nursing homes. The 1999 allowable costs were inflated by a vendor rate increase for each year after 1999 to account for increased costs. The 2000 examined cost report was used to set only the property and financing allowance rates for July 1, 2001.

Beginning in 1996, rebasing has been performed every three years, with 1999 being the last rebase year. The annual percentage of nursing home Medicaid rate growth from 1996 to 2000 was between 3% and 5%.

Current law is silent with regard to any future rebasing in the five non-capital cost centers (direct care, therapy care, support services, operations, and variable return). The law continues to provide for annual rebasing of the property and financing allowance rates.

Advantages of remaining with the current system:

- The growth in payment rates for the five non-capital cost components can be better controlled when rates are rebased less frequently.
- The system is familiar to those who use it or are affected by it, and would not become more complex.

Disadvantages of remaining with the current system:

- Knowledge in advance of what the rebase year will be could influence nursing facility operators to increase their costs for that year in order to increase their Medicaid payment rates. The increased spending may not properly reflect a nursing home's true spending patterns or costs over a longer period of time.
- The majority of the workload for rates analysts is concentrated into a short period of time, rather than being spread evenly over each year.
- Legislative analyses and rate projections would need to be adjusted in response to rebase changes when a rebase immediately follows the setting of the biennial budget once every six years. For instance, if the three-year rebasing cycle were allowed to continue as scheduled since 1996, the next rebase year would be 2002. Cost reports for 2002 would be submitted by March 31, 2003. These cost reports would be used to set rates effective on July 1, 2004. However, the legislative session beginning in January 2003 will determine the biennial budget for the July 1, 2003 to June 30, 2005 period. Analysis of the cost report would not be available to the legislature in time to be considered in assessment of the fiscal impact of rates during the second year of the biennium.

The following are some alternative approaches to the current system of rebasing all nursing home Medicaid payment rates every three years.

ANNUAL REBASING

One alternative is to rebase every year, for all cost components. Every year, the complete cost report of each of the state's approximately 260 Medicaid - contracted nursing facilities would be examined for accuracy and allowability. This is a similar payment system to that used to set nursing home rates until

1991. The difference is that prior to 1992, the assessment period was limited to three months. This alternative would increase the review time by one year.

Advantages:

- Rates would be more accurate, since every year the rates would be recalculated based on a facility's specific, most recent annual costs, and not just the costs of an earlier year adjusted by a vendor rate increase.
- Each nursing facility operator could better estimate the facility's rate in the upcoming year, based on its actual spending in the current year. This might permit better planning for each facility.

Disadvantages:

- Medicaid payment rates might, in general, increase more quickly. During the period when annual rebasing was used, Medicaid rates grew an average of 10% annually. While it is not possible to attribute these increases solely to the effect of annual rebasing, historically there has been a positive correlation between more frequent rebasing and higher payment rates.
- Annual rebasing would impose a heightened workload on the Nursing Home Rates Section of the ORM. The increased workload may require additional staff, or full time equivalents (FTEs), in order to complete effective full cost report examinations yearly.

REBASING ON THE AVERAGE OF TWO YEARS' COST DATA

In this alternative, cost reports would be filed and fully examined each year. Two years of examined costs and patient days would be averaged to set the non-capital Medicaid rate components. Additionally, two years of averaged per patient day costs for all nursing homes would be used to set the median cost limits (MCLs). Median cost limits are reasonableness limits on certain costs. Finally, two years of averaged facility case mix indexes would be used to calculate the cost per case mix unit. A case mix index is a score based on the average acuity levels of the nursing facility residents. This score is applied to the facility's allowable costs to determine its direct care rate. Medicaid payment rates would be adjusted for economic trends and conditions in the second year, followed by a new rebase cycle.

Costs for capital components would be reviewed annually, as they currently are, and Medicaid rates for the capital components would be established using the current methodology.

From 1992 through 1995, rebasing was done every other year. Although two years' costs were not averaged, the annual percentage of growth of nursing home Medicaid rates during these years was between 6% and 9%. By averaging

two years costs, the annual percentage of growth of nursing home rates is anticipated to fall somewhere between 6% to 9% yearly.

Advantages:

- Costs would be more evenly reflected, as highs and lows would be averaged.
- Payment rates would more expeditiously reflect facility spending and client acuity than they would under three year rebasing.
- There would be less incentive for a facility to “spend up” in the year of an anticipated rebasing than there would be under three year rebasing.

Disadvantages:

- The workload of ORM in these areas would generally increase from current levels because every year would be examined. The increased workload may require additional staff to set rates.
- The payment system, already complex, would become more so.
- Legislative analyses and rate projections would become more difficult due to the increased complexity of the rate setting methodology.
- Compared to a three-year interval for rebasing, averaging the costs of two years would most likely result in a more rapid increase of payment rates.
- When compared with any predetermined single year rebase schedule, limited incentives still exist to “spend up” during the two-year period.

**Alternative 3: REBASING EVERY THREE YEARS,
EXCLUDING HIGHEST AND LOWEST COSTS AND
USING MIDDLE COSTS**

This alternative would require that all cost reports be fully examined each year, in order to determine which years for each facility had the highest and lowest allowable costs. Costs for the first two years would be adjusted for economic trends and conditions, so that the data would be relatively equivalent when comparisons between the costs over the three years were made. The year that is determined to have the “middle-of-the-road” costs would be used to set future rates. Because the low cost year would be different for each facility, the MCLs would be set in the third year, using data from the middle years for all facilities.

The annual percentage of nursing home Medicaid rate growth from 1996 to 2000 was between 3% and 5%. This alternative method would keep the rate of growth to a similar rate.

Costs for capital components would be reviewed annually, as they currently are, and Medicaid rates for the capital components would be established using the current methodology.

Advantages:

- Years of unusually high or low expenses would be eliminated, leaving the year of middle expenses, which would presumably be a better reflection of expenses over time.
- Facilities would find little, if any incentive to boost expenses in a particular year to influence their rates.

Disadvantages:

- The workload of the ORM would be increased, possibly requiring additional staff, since all years must be examined.
- The payment system, already complex, would become more so.

**Alternative 4: REBASING EVERY THREE YEARS WITH
A RANDOM SELECTION OF FACILITIES EACH YEAR**

Under this alternative, the state's Medicaid-contracted nursing facilities would be divided into six categories:

- High Labor Cost Urban – For Profit
- High Labor Cost Urban – Not For Profit
- Urban – For Profit
- Urban – Not For Profit
- Non-MSA (Metropolitan Statistical Area)
- Hospitals.

Each year, after the preceding year's cost reports were submitted, and on the basis of a purely random drawing, one-third of the facilities from each category would be selected for examination of their cost reports. The next year, again on a purely random basis, one-half of the remaining facilities would be selected for examination of their cost reports. In the third year of the cycle, the remaining one-third of facilities would have their cost reports examined. The next year, the cycle would begin again. Division of the facilities into categories would ensure that a fair cross-section of each category would be examined each year. The categories would not be used for any other purpose.

MCL adjustments would take place annually based on the costs of the 1/3 of facilities examined. In each year, examination of facilities would take place between April and August. In September, the examined costs would be arrayed with the prior examined costs from the other facilities. All rates would be adjusted for economic trends and conditions to revise the MCLs, and rates would be set effective for July of the next year.

Examination appeals would be due by October before the July rate effective date, with the majority of resolutions taking place within three months. This extended period for examination, rate setting and appeals should result in firm rates for forecasting by the time the legislative session begins in January of the next year. Any legislative actions affecting the rate setting process could then be incorporated into the rate structure for rates effective in July following the session.

The annual percentage of nursing home Medicaid rate growth from 1996 to 2000, using our current three-year methodology was between 3% and 5%. The expectation is that this method would keep the growth at approximately the same rate.

Advantages:

- Maintaining the 3- year rebasing cycle should moderate NH rate growth.
- In each of the first two years of the cycle, facilities would not know if their cost reports were to be examined for that year. This would greatly reduce the ability to “game” the system by concentrating expenses in a rebasing year.
- The rate setting process would be evenly distributed over a three-year cycle, resulting in a more even workload for the ORM. The regulatory staff could devote time to other functions, and administrative appeals would be spread out over three years. In the long term, required staffing levels would be moderated.
- Over time, a more dependable expenditure pattern will emerge that will greatly enhance the capability to provide budget projections.

Disadvantages:

- The payment system, already complex, would become more so.
- Legislative analyses and rate projections would become more difficult due to the increased complexity of the rate setting methodology.

**Alternative 5: RELY ON THE VENDOR RATE TO
PROVIDE RATE INCREASES IN FUTURE YEARS**

As mentioned earlier, nursing home Medicaid payments are somewhat unique in that they receive rate increases due to rebasing. Most service providers receive payment increases through the mechanism of the legislatively determined vendor rate increase. Nursing homes have traditionally received both.

One option for Washington is to consider not rebasing any portion of the Medicaid nursing home payment rate in the immediate future. Under this option, the legislature could choose to continue using the case mix payment methodology to allow rates to reflect differences in the care needs of clients. However, the costs used to determine actual payment rates would not be rebased. Rather, costs from a base period would be used to determine rates and would be updated using the vendor rate increase.

Advantages:

- Payment rates would be more predictable. Increases would be based on the legislatively determined vendor rate rather than expenditure decisions made by nursing home operators.
- The payment system would be less complex and easier to administer.
- Payments to nursing homes would likely increase more slowly than under any of the rebasing options.

Disadvantages:

- Nursing home providers would presumably oppose this option because payment rates would likely not increase as fast as under any of the rebasing options. They would be likely to argue that vendor rate increases do not adequately reflect the increased operating costs.

**NOTE REGARDING ANNUAL CAPITAL COMPONENTS
REBASE**

While legislative policy has moved to less frequent rebasing for the five non-capital related cost centers in the nursing home rate, the capital components continue to be rebased every year. In a recent draft report looking at nursing home spending and quality of care in three states, the U. S. General Accounting Office (GAO) compared rate components between Washington and Ohio. The total payment rate for each state was approximately the same after adjusting for client needs and geographical wage differences. But in Washington, the capital payment was almost double that of Ohio. The GAO report does not specifically tie the difference to annual rebasing but it does conclude that the difference may be related to Washington's "comparatively generous capital reimbursement methodology" and its lack of limits to contain capital spending.

All of the above alternatives except the vendor rate increase allow for continued annual rebasing of the capital components. To allow for comparable savings and efficiencies by altering the rebase schedule for the capital components, other changes in the law outside the scope of this report should be considered.

If the legislature were to consider changes to the capital rate methodology, then the capital component could be effectively included in any of the alternatives being considered.

CONCLUSIONS

RCW 74.46.431 currently designates 1999 as the last rebase year. Except in relation to the King County AIDS pilot nursing facility (Bailey-Boushay House), which under RCW 74.46.835 is subject to an open-ended three-year cycle, DSHS has no legislative direction for future rebasing. DSHS understands that the present report is intended as one source of information and recommendations for the Legislature's consideration.

It is difficult, if not impossible, to quantify the projected results of the various alternatives considered in this report. However, in the experience of the ORM, two conclusions hold true across all payment system models:

- The more frequently costs are rebased, the faster payment rates are increased.
- To the extent that nursing facilities can take advantage of incentives in the payment system to increase their payment rates by consciously altering their behavior, they will. From the viewpoint of the nursing facility, this is a rational business decision.

The fiscal impacts of the various alternatives upon both the state and nursing facility providers would be mixed. To the extent that more frequent rebasing does indeed result in higher payment rates, then annual rebasing has a positive fiscal impact on the facilities and a negative fiscal impact on the state. Rebasing at longer intervals has a negative impact on the providers, and a positive impact on the state.

If the legislature chooses to allow rebasing of nursing home payment rates in the future, the three-year cycle with a random selection of facilities each year seems the most attractive. By reducing the incentive to increase costs, it promises to moderate growth in payment rates. By spreading out the work of the ORM more evenly, it promises to allow more effective use of state resources.

Another option would be for the legislature to choose a system for the adjustment of nursing home payments that is similar to that used for payments to providers of other services – i.e., providing payment increases through the legislatively-determined vendor rate increase, and not rebasing rates.